

Interview by Vinson & Elkins
with Rick Roeder
at footnote(s):

215, 306

M E M O R A N D U M

June 2, 2004

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TO: Paul S. Maco
Richard C. Sauer

FROM: Maria E. Bickerton

RE: *City of San Diego; Interview of Rick Roeder*

This memorandum summarizes the interview of Rick Roeder, a principal at Gabriel, Roeder, Smith & Company ("GRS") who served as the actuary for the San Diego City Employees' Retirement System from at least 1996 to present, conducted by Rick Sauer and Maria Bickerton.

This memorandum does not contain a verbatim or a near-verbatim transcription of this interview, but rather is a general summary of thoughts and mental impressions regarding the discussion. Significantly, it is organized to summarize issues thematically and, although it does chronologically follow the interview to an extent, it does not necessarily reproduce the order in which the interview actually occurred. There was no stenographer present at this interview, and given the nature of summarizing this type of discussion after the fact, this memorandum does not attempt to describe every statement or exchange, and it is possible that there are errors in this account. It also assumes familiarity with the facts of this case and does not provide context or explanation of every factual reference. It also does not attempt to completely describe or explain the complex actuarial issues discussed. Nor does it address issues of credibility or attempt to reconcile any differences between this interview and the accounts of other individuals.

This memorandum is subject to the attorney client and the attorney work product privileges, as it was prepared in connection with our providing legal advice to the City of San Diego (the "City") in connection with a potential SEC investigation regarding some of the matters discussed in this memorandum.

I. General Introduction

At the beginning of the interview, Mr. Roeder emphasized that he would prefer that all his answers to our questions be made in a public forum. It is his feeling that public statements tend to stand on their own. He has encountered problems with the distortion of information he has given in the past, and, therefore, he would prefer to represent the acts of GRS directly rather than through a third party.

Mr. Sauer stated that V&E is conducting a fact-finding inquiry, that we have no instruction from the City Council other than to prepare a complete and accurate report. Mr. Roeder agreed to speak with us on a voluntary basis. Mr. Sauer encouraged Mr. Roeder to correct any bad information that is out there for us. Mr. Roeder gave an example regarding his endorsement of Manager's II. Mr. Roeder said that others have claimed he gave an unqualified endorsement of Manager's II, but he never gave such an endorsement.

II. Actuarial Cost Methods

Mr. Sauer began a discussion regarding the actuarial cost methods used by the City. Mr. Sauer asked about the conversion from EAN to PUC in the early 1990s. Mr. Roeder explained that he did not serve as the actuary for CERS at that time, but he believes this conversion was a way for the City to reduce costs of funding CERS. Mr. Sauer asked if EAN is preferable to PUC, and Mr. Roeder said that from an actuarial standpoint EAN is preferable. He noted that EAN costs are more stable than PUC particularly because the average age of the CERS membership is increasing. The City experienced volatility with PUC in the early 1990s due to the increasing age of the City's workforce. Mr. Roeder confirmed that EAN costs have remained higher than PUC in the last four to five years. Mr. Sauer noted that another person we have interviewed said that PUC rates increased until they exceeded EAN rates in the early 1990s. Mr. Roeder said that he could not comment on this because he was not the CERS actuary in the early 1990s.

III. Manager's I

A. *Motivation for Manager's I*

Mr. Sauer asked if Mr. Roeder believed that the volatility of the PUC method was the reason for Manager's I. Mr. Roeder responded that he did not believe this was the reason. Mr. Roeder feels that, if the City was really concerned about this volatility, they simply could have switched to the EAN method immediately. However, this is not what Manager's I provided. At least at the surface, it seems to Mr. Roeder that the real reason behind Manager's I was that the City wanted contribution relief. Mr. Sauer asked if the City was having budgetary trouble in 1996, and Mr. Roeder said that he does not have any special knowledge on this issue.

B. *Mr. Roeder's Position on Manager's I*

Mr. Sauer asked what Mr. Roeder's reaction to Manager's I was. Mr. Roeder responded that he was not thrilled by it, but he was satisfied with it because it contained a firewall. Mr. Roeder believes Manager's I was better than Manager's II under either interpretation of Manager's I. According to Mr. Roeder, under Manager's I upon hitting the 82.3% trigger, the City would have been required to contribute within one year either an amount sufficient to bring the funded ratio back to 82.3% (i.e., the hard floor) or the full PUC rate (i.e., the soft floor). With Manager's II, the City would have six years to ramp up to the full PUC rate, and there was no requirement that the funded ratio be restored to 82.3%. Mr. Sauer noted that there was a one-year lag under Manager's I if the 82.3% floor was hit, the one year lag in actuarial calculation would cause a delay in the City's required response. Mr. Sauer asked if Mr. Roeder was concerned about this

lag. Mr. Roeder said that he could live with the one-year lag but noted that the funded ratio could have fallen into the seventies before being restored to 82.3% because of this factor.

C. *Manager's I Projections*

Mr. Sauer queried what the major factors were that caused the projections made under Manager's I not to materialize. Mr. Roeder responded that the benefit levels were vastly different. He noted there were two benefit enhancements after Manager's I. He also attributed some of the difference to the increasing retiree medical costs and the bear market.

D. *November 1998 Letter to Mike Phillips*

Mr. Sauer presented to Mr. Roeder a letter that Mr. Roeder wrote to Mike Phillips in November of 1998. Mr. Sauer noted that it appeared from the letter that there was a concern about the rising UAAL going up. The letter indicated that one reasonable hope was that the assumptions could be changed to eliminate or reduce the shortfall, but the actuarial methods used to calculate funding actuarial levels should also be used for expensing under GASB 25. The letter also referred to a conversation between Mr. Roeder and a GASB representative. Mr. Sauer asked Mr. Roeder what the conversation with GASB entailed, and Mr. Roeder responded that it was to determine if GASB would add the corridor funding method to its approved methods. Mr. Sauer asked what was intended by a sentence in the letter that began "If we can say the corridor method was implemented . . ." Mr. Roeder responded that the concept was that they were trying to see if GASB would be flexible and expand their methods. In the end, GASB did not do so. Mr. Roeder did not remember whether GASB said "no" in response to the original request or simply never got back to him. Mr. Roeder explained that he did not receive a response, so after approximately 13 months, he followed up with a phone call. However, GASB never approved the corridor method.

Mr. Sauer informed Mr. Roeder that there was a comment in the footnote to the City's financial statements about an application to GASB for the corridor method. Mr. Sauer asked Mr. Roeder at what point this comment should have been out of the financial statements. Mr. Roeder said he made the request to GASB two different times. Mr. Roeder estimates that it became certain about 18 months ago that GASB would not approve the corridor method. He said that he should still have the second request in his records and will send it to Mr. Sauer.

Mr. Sauer then turned to another statement in the letter regarding bifurcated rates and the net pension obligation. Mr. Roeder said that he did not recollect the meaning of this statement.

IV. Manager's II

A. *Mr. Roeder's Position on Manager's II*

Mr. Roeder said that he had three basic problems with Manager's II:

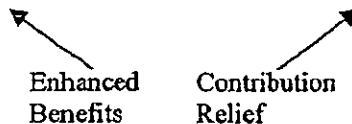
- (1) He did not believe that the CERS board should be involved in collective bargaining;
- (2) Manager's II eviscerated the 82.3% floor; and
- (3) Compared to Manager's I, less money would go into the system under Manager's II if the trigger was hit (which looked likely).

Mr. Roeder explained that he acquiesced to Manager's II but admonished that the Board should not be involved in collective bargaining due to conflict of interest concerns. Mr. Roeder presented this concern to the CERS board with a slide entitled "The Role of a Fiduciary." Mr. Roeder said he did not recall any significant dialogue resulting from this point. Mr. Sauer noted that this issue regarding conflict of interest really went back to Manager's I. Mr. Sauer asked whether Mr. Roeder raised any concerns regarding conflict of interest with respect to Manager's I, and Mr. Roeder said he did not recall raising this issue at that time. Mr. Roeder agreed that the issue went back to Manager's I but explained that he felt more comfortable with Manager's I because there was a firewall with a hard 82.3% floor. He believed that there was more support actuarially for Manager's I because the funded ratio at the time was better. Overall, Mr. Roeder feels that Manager's I was better, although it was flawed with some ambiguity.

Mr. Roeder said that he presented materials to the CERS board showing that, under Manager's II, the funded ratio could fall down into the sixties (i.e., 60%). This was part of a July 2002 public presentation of projections Mr. Roeder had been asked to perform for the CERS board. Mr. Sauer asked Mr. Roeder if the July meeting at which this presentation was made was after Bob Blum began to raise concerns. Mr. Roeder responded that Bob Blum did not raise concerns as much as GRS.

(1) "Which Way Ya Goin?" Slide

Mr. Sauer had some of the slides Mr. Roeder prepared for the July 2002 presentation, including the following depiction entitled "Which Way Ya Goin?":



(a) Benefit Enhancements

Mr. Sauer asked about to discuss the benefit enhancements listed in the slide entitled "Which Way Ya Goin?" The first was a 1991 Safety Enhancement, which Mr. Roeder explained was an increase in the multiplier. Next was a 1991 early retirement window, which Mr. Roeder said may have been the result of a "meet and confer" but was not certain. The third enhancement listed was the 1996 Manager's Proposal.

The fourth enhancement listed was a 1997 allocation for increased employee contributions, which Mr. Roeder explained was an amount to be applied from a reserve to cover the additional employee contributions that would result from the benefit enhancement of Manager's I. (Mr. Roeder noted that, since the Municipal Code provides that employees will share the cost equally with the City, a portion of the cost of the enhancement was to fall on the employees.) The reserve initially contained approximately \$40 million, was held outside of the system, and did not become countable for valuation purposes until applied. Mr. Sauer asked if this was the same as a pick-up, but Mr. Roeder distinguished between this reserve for increased employee contributions and a negotiated pick-up. According to Mr. Roeder, they function the same but the 1997 reserve for increased employee contributions was to cover a particular benefit enhancement, whereas a negotiated pick-up is not tied to any particular benefit enhancement.

Mr. Roeder explained that the reserve for the 1997 reserve for increased employee contributions was taken out of fund assets. Mr. Sauer asked why this was done, and Mr. Roeder responded that he did not know. He speculated that it may have been part of the negotiations or that, because the system was experiencing such large gains on investments, some may have thought that investment losses would never be experienced again. Mr. Sauer asked if this was a reasonable assumption, and Mr. Roeder responded that it was not. Mr. Roeder believed there would be a bear market 3 or 4 years before it actually occurred.

The final item on the list of enhancements was the 2001 Corbett benefits.

(b) Contribution Relief

Mr. Sauer also inquired about the elements of contribution relief listed in the slide entitled "Which Way Ya Goin?" The first element was the adoption of the PUC actuarial cost method, which, according to Mr. Roeder, produced a lower annual cost than the EAN method at the time.

The second was the 30-year amortization starting in 1991. Mr. Sauer requested that Mr. Roeder explain the use of a 30-year amortization period for some purposes and the use of a 40-year amortization period for other purposes. Mr. Roeder explained that CERS adopted a 30-year amortization period starting with the 1991 valuation for funding or contribution purposes. Each year the period decreases by one. For expensing purposes, however, a 40-year amortization period is used (i.e., for calculating the NPO, etc.). This complies with GASB requirements. Mr. Roeder explained that he does not find the use of a different amortization period for funding purposes to be objectionable in this case because the City's contribution rates are negotiated and not related to the actuarial valuation. Mr. Sauer asked if the City amortizes the NPO for financial reporting purposes, and Mr. Roeder said he was not aware of what they do for financial reporting purposes. After the interview, Rick Roeder commented on a draft of this memorandum that the question was unclear and crossed out the sentence.

The third item listed under contribution relief was 5+ years paying significantly less than the actuarial rate. Mr. Roeder explained that this was the result of Manager's I.

The fourth item listed was the assumption change phase-ins. Mr. Roeder explained that the City elected to phase-in some of his recommendations to change actuarial assumptions. For example, an assumption was used to reduce projected disability benefits due to a disability offset provision, but in practice the provision never applied. Therefore, Mr. Roeder recommended the assumption be eliminated, and the City chose to phase it out over a certain period of time. In addition, employee turnover assumptions were found to be too high based on experience, which affected the City's discount for pick-ups. This relates to employees who leave the system before their benefits are vested. In such cases the City recovers the portion of the employee contributions to CERS that the City picked-up as a result of the meet and confer process. The change in this assumption was gradually made over several years.

Mr. Roeder commented that the contribution relief would allow the City to not fund at the actuarially computed rate until the FY ending June 30, 2009. He noted that would conveniently be after certain City officials on fixed terms would be out of office. According to Mr. Roeder, Bruce Herring was one common denominator between Manager's I and Manager's II.

(2) Letter of November 5, 2002

Mr. Sauer raised the topic of Mr. Roeder's letter to the CERS board dated November 5, 2002. Mr. Sauer noted that Mr. Roeder wrote in the letter that it was within the board's discretion to give the City a transition period to ramp up to PUC rates and that, if the board decided a transition period was needed, the ramp-up proposed in Manager's II was reasonable. (After the interview, Mr. Roeder indicated that he believes his letter stated that it would be preferable not to provide a PUC transition "ramp up" period but that the board would need to exercise its judgment in deciding whether a transition period was needed.) Mr. Sauer asked if Mr. Roeder would write the letter in the same manner today. Mr. Roeder responded that he would not change the way it was written significantly. He presented the pitfalls, and it was up to the CERS board to decide if it could live with them.

B. *Mr. Roeder's Position on Effect of Funded Ratio Floor in Manager's II*

Mr. Sauer explained his understanding that the original proposal for Manager's II was to drop the floor to 75% and that, ultimately, the 82.3% was maintained although the City would be given a five-year period to ramp up to the full actuarially computed contribution (based on the PUC method). Mr. Roeder responded that he did not recall all the details of various iterations of Manager's II. In theory, he did not believe there was any real floor in Manager's II. As he described it, the ramped-up rate that is calculated under the following formula:

$$\text{Ramped-Up Rate} = \text{City Baseline Rate} + ((\text{Actuarial Rate} - \text{City Baseline Rate}) / \text{number of years to FY2009})$$

However, Mr. Roeder emphasized that there is nothing that ensures that the funded ratio will remain at or above 82.3% (i.e., there was no hard floor). In his mind, there is no floor in Manager's II.

Mr. Sauer focused on Mr. Roeder's objection to the five-year ramp up in Manager's II. Mr. Sauer asked how significant it was to give the City this transition period. Mr. Roeder said that he prepared projections (with at least three different scenarios) regarding the impact of the transition period to the CERS board and that he would provide these projections to us. In fact, Mr. Roeder noted that he presented scenarios to the board where the funded ratio could drop into the sixties. Mr. Sauer asked whether Mr. Roeder estimated a continued decline even if the 8% investment return assumption were met. Mr. Roeder said that his projections did show a continued decline even with an 8% investment return.

C. Mandated Actuarial Assumptions under Manager's II

Mr. Sauer initiated a discussion on the mandated actuarial assumptions under Manager's II. Mr. Sauer commented that, under Manager's II, if the 82.3% floor was never hit, the actuarial assumptions would not affect the City's contribution rate until 2009. Mr. Sauer asked why the City would feel the need to freeze the actuarial assumptions. Mr. Roeder responded that the City did not want uncertainty and was worried about an actuarial liability increase. Mr. Sauer asked if this was with respect to the UAAL or the funded ratio, and Mr. Roeder said that it was with respect to both because they are related to each other.

Mr. Sauer asked if in 2002 there was any reason to expect a significant change in actuarial assumptions. Mr. Roeder noted that he did an experience study and provided a report with some recommended assumption changes to the CERS staff in the middle of 2002. Mr. Roeder is not sure when it actually got to the CERS board. Mr. Roeder thinks it is possible that the CERS staff may have shared the report with the City. Most of these recommendations were adopted, and Mr. Roeder stated that these changes were not necessarily significant.

D. Mr. Roeder's Position on the Motivation for Manager's II

Mr. Sauer asked whether the funded ratio as of June 30, 2002, was known at the time Manager's II was being considered. Mr. Roeder explained that the funded ratio as of June 30, 2002, was not known until December 2002. Mr. Sauer asked if it was obvious that the funded ratio would be below 82.3%, and Mr. Roeder felt that everyone knew it was likely although he did not know if the City ran its own projections. Mr. Roeder believes this was the reason for Manager's II. He feels that Manager's II never would have happened if it was not considered likely that the funded ratio would drop below 82.3%.

E. Reaction to Mr. Roeder's Positions on Manager's II

Mr. Sauer asked if it was fair to say that Mr. Roeder's presentation was in opposition to Manager's II. Mr. Roeder rephrased it as "pointing out pitfalls." Mr. Roeder said that he did not want to appear biased before the CERS board, but he had problems with Manager's II and expressed them. Mr. Sauer wanted Mr. Roeder to discuss the reaction he received to his presentation. Mr. Roeder said that only two or three members of the CERS board voiced strong concerns, including Diann Shipione, Mr. Rhodes (sic) and Dick Vortmann. Mr. Roeder said he

did not know the politics, but no one seemed to be strongly in favor of Manager's II because Bob Blum and Mr. Roeder were critical of it.

Mr. Roeder recalls that Bruce Herring was at a presentation to the CERS board in June. Mr. Roeder noted that he and Bruce Herring had a private conversation after the presentation. Mr. Roeder said that Herring was less than complimentary and not thrilled with Mr. Roeder's presentation. Mr. Sauer asked if Herring's comments caused Mr. Roeder to change his view, and Mr. Roeder responded that they did not.

Mr. Sauer later asked if Mr. Sauer felt any pressure to mitigate his opposition to Manager's II. Mr. Roeder said that he was not scared to express his opinion; there was no overt pressure. He said that he backed off a little because Bob Blum thought there was a practical advantage to Manager's II. Mr. Roeder explained that he acquiesced in the face of a strong legal opinion from Bob Blum, who believed that Manager's I was not workable because of ambiguities. However, Mr. Roeder stated, after the interview, that even in the last public meeting in November, he reiterated that no public pension board should be involved in setting benefit levels."

V. Use of Surplus Earnings

A. *In General*

Mr. Sauer confirmed with Mr. Roeder that the expected investment return for CERS was 8%. Mr. Sauer queried whether this was true with the diversion of surplus earnings to fund contingent benefits. Mr. Roeder said that if assets are diverted, it pushes the contribution rate up and could require a lower assumption for the investment return. Mr. Sauer asked if there was any limit on the extent to which an employer can divert surplus in good years without clearly undermining the soundness of the system. Mr. Roeder responded that, if you do anything year after year, eventually it will come back to bite you. Mr. Sauer noted that Mr. Roeder had made a point in some of the annual actuarial valuation reports regarding the risks of diverting surplus earnings in good years. Mr. Roeder affirmed this and indicated that the undercontributions combined with the policy on contingent liabilities limited the funds available for the actuarial liability.

Mr. Sauer asked if there was any guidance on the extent to which surplus earnings can be used for purposes other than bolstering the funded status of the system. Mr. Roeder responded that there is no policy in GASB in this regard. He noted that four things govern: (1) the Municipal Code, (2) fiduciary duty under case law, (3) theoretically, generational tax equity (i.e., trying to level costs over generations), and (4) proposition 162 (which passed in 1992). Mr. Sauer requested that Mr. Roeder comment on whether he believed proposition 162 affected CERS and the way it does business. Mr. Roeder said that proposition 162 provides that the CERS board owes a primary duty of loyalty to its beneficiaries and noted that the board has been very loyal to the beneficiaries in the sense that the beneficiaries have received greater benefits as a result of the board's actions.

Mr. Roeder also commented that about half of the independent systems in California are "1937 Act" systems, and the 1937 Act contains provisions for the use of excess earnings. Three

counties (Alameda, Tulare, and Kern) have a 50/50 surplus earnings provision, allowing 50% of surplus earnings to be diverted. Notably, San Diego is not covered by the 1937 Act directly, but, in the early 1980s, the City began to adopt provisions that allowed access to surplus earnings (i.e., the 13th check and later the retiree health benefits). Mr. Roeder believes that provisions allowing for the diversion of excess earnings have bastardized the meaning of excess earnings. He noted that some consider there to be no true excess until the funded ratio is around significantly above 100%.

Mr. Roeder recognized that the use of surplus earnings was not unique to San Diego. He noted, however, that it was not as common outside the state of California.

B. Use of Surplus Earnings to Pay Retiree Health Benefits

Mr. Roeder noted that Los Angeles and San Jose actuarially fund for retiree medical benefits but that most do not in California. Mr. Roeder also commented that retiree medical benefits are not an obligation of the retirement system. Rather, to the extent the benefits are vested, they are an obligation of the City. The retirement system is just a convenient conduit to pay these benefits. Mr. Roeder said there is no requirement that retiree medical benefits be actuarially funded.

Mr. Sauer noted that there is a reserve established for retiree medical benefits and that nothing in the Municipal Code appears to require this reserve. Mr. Sauer asked if Mr. Roeder knows why CERS funds this reserve. Mr. Roeder said he did not know why CERS assets were set aside for this reserve.

Mr. Sauer asked if San Diego is more or less aggressive than others with the use of surplus earnings. Mr. Roeder responded that it was hard to generalize. He noted that the funded ratio for San Diego CERS was among the lower ones and that the use of surplus earnings was one factor. He also felt that, if a survey was done, San Diego's retiree medical payments would probably be among the highest. Mr. Roeder explained that some other entities don't explicitly pay premiums the way San Diego does. Rather, they pay a maximum dollar amount so that there is a cap on the cost to the entity. San Diego has no such cap. Mr. Roeder said he believes that, while retiree medical benefits have increased greatly, this is being ameliorated to a certain extent and that the increases will be smaller in the next few years.

Mr. Sauer commented that the retiree medical element of the waterfall has become much more substantial than it originally was. Mr. Sauer asked if it would inevitably suck all of the surplus earnings out of CERS. Mr. Roeder noted that CERS has had some exceptionally good and some exceptionally bad years. Because surplus earnings were used to pay contingent benefits, the earnings from the exceptionally good years were not available to balance out the exceptionally bad years. Mr. Roeder said that he explained this to the CERS board through a presentation slide entitled "Shaving Off the Mountaintops." In this presentation, Mr. Roeder expressed some preference for a lower investment return assumption based on the history of the waterfall use of surplus earnings. He proposed decreasing the projected investment return by 25 basis points, although he noted that this would not, in and of itself, solve the problem if the use of surplus earnings to pay contingent benefits continues as is. Mr. Sauer asked if the preferable solution

would be to get rid of the contingent benefits, and Mr. Roeder agreed that this would be the financially conservative approach (i.e., the City may need to tighten its belt).

C. *Use of Surplus Earnings for Corbett Liabilities*

Mr. Sauer noted that one of the contingent benefits included in Mr. Roeder's slide entitled "Shaving Off the Mountaintops" was the Corbett liabilities. The slide shows a 7% allowance for the contingent portion of these liabilities. Mr. Roeder explained that he was instructed not to include these liabilities in the actuarial valuation, and he presented the slide to show the potential impact of the contingent Corbett payments. Mr. Roeder noted that there was not unanimity among the CERS board members to exclude these liabilities from the actuarial valuation. Mr. Sauer asked if there was any guidance on when something is contingent or non-contingent. Mr. Roeder said it is a gray area. However, he said his view is that, if it is certain that a benefit will be paid eventually one way or another, it should probably be included in actuarial liabilities. However, some strongly believed the Corbett liabilities were legally a contingent benefit. Mr. Sauer noted that, under GASB, the actuary has some discretion on what is contingent. Mr. Roeder notes that GASB only relates to expensing and not funding. Mr. Roeder commented that there could have been a distinction made to treat the Corbett liabilities as contingent for purposes of expensing and not for purposes of funding (as with the amortization periods discussed above), and Mr. Roeder would not have opposed such a distinction because the City's funding rate was not based on the actuarial valuation.

VI. Estimating Retiree Health Liability

Mr. Sauer referred to a CERS staff report to the Rules Committee dated February 5, 2003. It contains a figure on the present liability for retiree health benefits equal to \$1.1 billion, and Mr. Sauer noted that there was a great deal of concern about this. Mr. Roeder explained that this was a figure estimated by Larry Grissom that includes the present value of future benefits for active employees (i.e., for services not yet rendered) as well as accrued liabilities. This is not the same as the unfunded liability, which accounts only for the accrued liabilities. Mr. Roeder said the \$1.1 billion figure was a "SWAG," i.e., some wild-assed guess. Mr. Roeder explained that he gave Larry Grissom a two-page letter containing some figures on the retiree health liability. However, the figures in the letter were bifurcated between the unfunded liability and the additional present value of benefits for actives.

Mr. Sauer inquired about GASB's new rule on retiree health benefits. When the final statement is out, Mr. Roeder said it will mean that in FY 2006 or 2007, governmental entities will not have to fund but will have to recognize these liabilities in their financial statements.

Mr. Sauer asked whether the methodology exists to calculate the liability of retiree health benefits with any degree of certitude. Mr. Roeder responded that such a methodology does exist. Mr. Roeder noted that he will be providing a report to the Pension Reform Committee with figures that are more accurate than the \$1.1 billion figure. It will be informal, however, taking averages and extrapolating for inflation. Mr. Roeder explained that he would not be analyzing

subgroups, but that Leslie Finertie would be preparing a more detailed report. Mr. Roeder said that he would provide Mr. Sauer with his report on the retiree medical benefits.

VII. CERS Funded Ratio

A. *Significance of Declining Ratio*

Mr. Sauer queried whether there is any guidance on how big the unfunded actuarial accrued liability ("UAAL") can be before the system becomes unsound. Mr. Roeder said that he was not aware of any hard and fast rule on this. He explained that it is partly viewed as a function of momentum. That is, if an entity has a funded ratio of 70% but is paying actuarial costs each year, then the system is probably fine. However, if the entity is not paying actuarial costs, downhill momentum builds, which may mean the system is at more risk. Mr. Roeder noted that he explained this to the CERS board through a presentation slide depicting a skier going downhill. Mr. Roeder said he would send Mr. Sauer this slide.

Mr. Sauer inquired about the July 2003 PFN projections. Mr. Roeder confirmed that he provided some projections for this. Mr. Roeder noted that the City's projected UAAL as of FY 2004 may be significantly larger. Mr. Roeder explained that, for the first 9 months of the fiscal year, the markets were still down, so it is likely that the funded ratio will be down. However, Mr. Roeder recognizes that the markets changed with 3 months left in the fiscal year, so it is not certain where the funded ratio will come out.

Mr. Sauer noted that the language Mr. Roeder used in his actuarial valuation reports changed in 2001. Previously, he had indicated that the financial condition of the system was "sound." Beginning in 2001, he stated that the financial condition of the system was "adequate." Mr. Sauer asked what triggered this change. Mr. Roeder responded that it was triggered by the decline in the funded ratio and the increasing gap between the actuarially computed rate and the Manager's rate. Mr. Roeder said he felt it was more accurate to say "adequate" rather than "sound." As historical background, Mr. Roeder noted that, during the last bear market in the late 70s and early 80s, funded ratios for many pension plans were around 50%. Thus the change in language was not intended to raise alarm but to simply bring attention to the declining ratio.

B. *Reason for Declining Ratio*

Mr. Sauer initiated a discussion regarding the cause of the fall in the funded ratio. Mr. Roeder noted that the period that you are examining makes a huge difference in the attribution. He believes this may explain any difference between Mr. Roeder's attribution analysis and Leslie Finertie's attribution analysis. Mr. Roeder said he has not reviewed Leslie's document in detail but believes Leslie's analysis went back to June 30, 1997.

Mr. Sauer inquired about Mr. Roeder's letter to the Pension Reform Committee dated May 18, 2004. Mr. Sauer asked if Larry Grissom had any input on the letter. Mr. Roeder said that Larry reviewed the letter but made no substantive changes. Mr. Sauer also asked about the reference to three non-contingent benefit increases that are reflected in the seven-year analysis. Mr. Sauer

questioned whether there were not more than three benefit increases during this period, especially a 2000 increase. Mr. Roeder explained that the 2000 increase was deemed to be part of Corbett.

Mr. Roeder's letter indicates that, over a 10-year period, the investment return for CERS was 8%, exactly equal to the investment return assumption used by the actuary. However, Mr. Sauer noted that an actuarial investment loss is reflected in the pie charts. Mr. Roeder explained that the pie charts show a different time frame in which the return was less than 8%. Therefore, Mr. Roeder explained there was some actuarial investment loss during the period represented in the pie charts. Mr. Roeder said that he will figure the investment return rate (on a time-weighted and dollar-weighted basis) for the seven-year period reflected in the pie charts and provide it to Mr. Sauer.

Mr. Sauer asked if it was mainly ex-officio members of the CERS board attributing the drop in the funded ratio primarily to investment losses. Mr. Roeder responded that it was two non-ex-officio members who have been saying this, and Mr. Roeder noted that it is true if you are looking back over the short-term. Mr. Sauer and Mr. Roeder discussed the fact that it has been said that 85% of the loss was attributable to investment losses. Mr. Roeder clarified that this was correct with regard to the last 12 months and considering only actuarial gain or loss. The intentional undercontributions under Manager's I and II did not constitute actuarial gain or loss.

Mr. Sauer asked whether, in preparing the pie charts, Mr. Roeder figured out the affect of each benefit increase individually. Mr. Roeder said that he did but that he does not have a report on these individual figures. They were compiled into one category for the pie chart.

Mr. Sauer then inquired about the principal areas of non-investment actuarial loss listed in Mr. Roeder's May 18, 2004 letter. One of the items listed was significant service purchase subsidies, and Mr. Sauer asked whether these were supposed to be neutral. Mr. Roeder responded that there was no sinister intent but that the initial rates established for the service purchases were inadequate. Mr. Roeder guesses that someone may have added the normal cost and the employee rate. He noted that the rates in the actuarial report assume level contribution rates throughout a career, but, if an individual is above the average age, the rate should be higher. In addition, the rates were not updated with benefit increases. Mr. Roeder speculates that this may have been due to oversight or just the financial psychology of the times as a result of the bull market. In addition, representatives of the union were against updating the rates because their constituency did not want it.

Mr. Sauer then asked about the actuarial loss due to the DROP incidence. Mr. Roeder said he would not lay a lot of the problem on DROP. Mr. Roeder explained that the effect of DROP was still not clear, but his gut told him that it did not have a huge impact. This could not be rigorously analyzed until the end of the 5-year maximum period (i.e., 2002, which was after the end of the last experience investigation period). The change in benefit multipliers (i.e., the elimination of increases in the multiplier with additional age) also made DROP more attractive. Mr. Roeder said that, overall, DROP was not a non-issue, but it was a smaller issue. He noted that early retirements could also be attributable to factors other than the DROP.

Mr. Sauer turned again to the pie charts and asked why Mr. Roeder had two pie charts for each period analyzed, one with a one-year lag and one without this lag. Mr. Roeder explained that CERS uses a one-year lag, but he feels that the pie chart showing the analysis without the one-year lag is more accurate. The pie chart without the one-year lag compares the Manager's rate for the year at issue to the previous year's actuarial contribution rate. Mr. Roeder provided the following hypothetical example:

	<u>Actuarial Rate</u>	<u>MP Rate</u>
6/30/00	15%	9%
6/30/01	20%	10%
6/30/02		11%

Under this example, with the lag, the Manager's rate for 2002 is compared with the actuarial rate for 2000, resulting in a shortfall of 4% (i.e., 15% - 11%) for 2002. Without the lag, the Manager's rate for 2002 is compared with the actuarial rate for 2001, resulting in a shortfall of 9% (i.e., 20% - 11%) for 2002.

Mr. Sauer asked about the investment return assumption used to determine the time value of money for the pie charts. Mr. Roeder responded that he used the 8% assumption. He noted that one could use the actual market rates of return or the actuarial rates of return, but he felt the use of 8% was reasonable. If a different rate had been used, it probably would not have made a significant difference.

VIII. Actuary's Review of Pension Disclosures

Mr. Sauer referred to a letter Mr. Roeder wrote to Terri Webster dated November 10, 2003. In this letter, Mr. Roeder proposed that the actuary review the City's pension disclosures each year, particularly if statements are going to be attributed to the actuary in such disclosures. Mr. Sauer informed Mr. Roeder that Cecelia San Pedro said that she did show Mr. Roeder the disclosure for the 2002 fiscal year. Mr. Roeder said that he did not recall ever seeing this disclosure in advance. He said that, if he had seen it, he would have corrected the numerous inaccuracies, including the reference to June 1996.

Mr. Sauer requested that Mr. Roeder review the language regarding the funding policy of CERS in a 2003 bond offer. In reviewing the funding policy language, Mr. Roeder noted that the first paragraph was arguably not right because the CERS funding policy was trumped by the Manager's Proposals. Mr. Roeder said the second paragraph looked reasonable. Mr. Roeder was not sure about the accuracy of the numbers in the third paragraph regarding the employee contributions, but he thought they might be a little misleading. Specifically, he said that the numbers were accurate if you include the pick-up. However, the employees are not paying the pick-up portion out of their pockets (i.e., it's not being deducted from their pay); rather the City pays the pick-up. Mr. Roeder said this is probably just a detail.

Continuing his review, Mr. Roeder noted a statement in the disclosure that \$40.8 million applied to normal cost. Mr. Roeder was not sure if this number was right. He would have guessed that it would have been higher. Looking at the 2002 valuation report, the normal costs are not covered by the Manager's rates. Mr. Roeder said that he worked with the City on the calculation of the net pension obligation, although he did not do so specifically with regard to the financial statements. Mr. Roeder indicated that the 1996 date referenced was way off and that the inflation assumption should have been 4.25% (it was not updated). He agreed with the statements in the disclosure that the corridor funding method is unique and that it is not approved by GASB. He was not sure about the \$39 million figure referenced.

Mr. Roeder commented on a sentence that began "Even though the shortfall is funded in a reserve . . ." Mr. Roeder and Mr. Sauer referred to page 24 of the 2002 valuation report, which showed no reserve for the net pension obligation. Mr. Roeder noted that these reserves were included in the actuarial assets for purposes of the valuation; they were not set aside for a "rainy day."

Mr. Sauer noted that there was some analysis with respect to Manager's I indicating that it would cost approximately \$100 million. However, this was supposed to be covered by a number of reserves. Some of the reserved money was inside the system and some was outside. At some point, these reserves were folded into the employer contribution reserve. Mr. Sauer asked if Mr. Roeder recalled any of this. Mr. Roeder said that he was either not involved or has forgotten. Mr. Sauer asked Mr. Roeder if he did not remember any big reserves outside of system assets set aside to cover this. Mr. Roeder responded that he was certainly not aware of any big reserves outside of the system to cover the net pension obligation. However, there were a lot of gains in the system at that time, and he said his recollection was fuzzy.

IX. Recommendations

Mr. Sauer asked Mr. Roeder to comment on what he thought the City should do to improve the financial condition of CERS. Mr. Roeder believes the City needs to figure out what it can afford to pay and keep that in mind in collective bargaining. He said that it seems to be more of a benefits issue than a funding issue, although he clarified that he was not saying that there is no funding issue. In Mr. Roeder's view, the bigger issue is the disconnect between what the City can afford to pay and what they agree to in collective bargaining. Mr. Roeder believes the City needs to take more of a long-term view. It appears to him that the City has not done any long-term planning in this regard. Mr. Sauer noted that Mr. Roeder had in the past commented on the political view being very short-term, and Mr. Roeder confirmed these statements. Mr. Roeder noted that there were only 2 votes against Manager's II, Diann's and, if he recalls correctly, the safety representative's. There were three votes from City officials, the Treasurer, the Auditor, and the City Manager, but they all voted for Manager's II.

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